



National Economic Trends



Is Inflation Dead?

U.S. consumer prices (all items) have increased less than 3 percent in the past year. Given the usual problems in measuring changes in product quality, some analysts think this performance is tantamount to price stability. Furthermore, most analysts do not see inflation as a serious threat in the near term. Such conclusions usually are based on the notion that the economy is operating well below its potential or that the M2 money stock is growing slowly. To assess the prospects for inflation in the near-term future it is useful to know how tight these relationships are.

Two simple and popular models provide alternative explanations of the inflationary process. One is based on a level of output consistent with a non-accelerating inflation rate, or what is usually referred to as potential GDP. According to this "output gap" view, there is little upward pressure on prices until the economy's level of production approaches its potential as determined by the size of the labor force and productivity. The other is the P-star model, which uses a measure of the money stock to determine an equilibrium price level. According to this view, if the price level

exceeds its equilibrium level, there is downward pressure on prices, and vice versa. Both models focus on excess aggregate demand as the determinant of inflation, but differ in their interpretation of how the inflation mechanism works.

The table below shows what the output-gap model and two versions of the P-star model would have predicted for consumer prices (less food and energy) for 1993 and what they imply for 1994. This measure of inflation rose at an estimated 3.1 percent rate in 1993. As the table shows, two of the three models accurately forecast that inflation would decelerate from 3.4 percent in 1992. For 1994, the models show contrasting forecasts. Both the output-gap and M1 version of the P-star model forecast an acceleration in inflation. The M2 version of the P-star model, on the other hand, projects a sharp deceleration. The most striking feature of these models, however, is their lack of precision. They all show a wide range between their upper and lower 90 percent statistical confidence limits, which suggests that forecasting inflation in the short run is still a very imprecise exercise.

—Keith M. Carlson

FORECASTING INFLATION: TWO SIMPLE MODELS

<u>Model</u>	<u>1993 inflation forecast</u>	<u>1994 inflation forecast</u>
Output-gap	3.3% ± 1.6%	3.2% ± 1.6%
P-star		
M1 version	3.6 ± 1.6	3.9 ± 1.6
M2 version	3.0 ± 1.5	2.2 ± 1.5

Note: Inflation is measured as percent change from fourth quarter to fourth quarter in consumer prices less food and energy.

Views expressed do not necessarily reflect official positions of the Federal Reserve System.

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